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Happily Ever After?

Investment Funds that Live with ERISA, For Better and For Worse (Part 4 of 5)

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This is the final installment in our five-part serialization of a treatise chapter by Dechert LLP partner Andrew Oringer. The chapter analyzes ERISA as it applies to private fund managers, references relevant authority and highlights critical compliance issues. This article discusses trust requirements, custody, ERISA's bonding rules, reporting of investments and direct filings with the Department of Labor, reporting issues (relating to compensation, hard-to-value assets and gifts and entertainment) and prime brokers. The fourth article in this series addressed self-dealing issues relating to fee structures, certain special issues for plans of financial institutions, services for multiple funds, payment or reimbursement of expenses, employer securities and employer real property and certain miscellaneous exceptions (including foreign exchange and cross trading). The third article focused on prohibited transactions, qualified professional asset managers, the "service provider" exemption and the exemption for compensation for services. The second article covered fiduciary duty considerations, including delegation, allocation of investment opportunities, varied interests of fund investors, indemnification and insurance, investments in portfolio funds, enforcement-related matters and diversification requirements. And the first article discussed the "plan assets" rules and rules for the delegation and allocation of fiduciary responsibility.

Trust Requirements

Unless an exception applies, ERISA requires that plan assets be held in trust.[1] That requirement may raise concerns for Plan Assets Funds, in particular for a fund of funds that invests in other Plan Assets Funds. By regulation, however, holding in trust at a top-tier level results in the satisfaction of trust requirements at lower tiers.[2] While trust issues cannot always be easily handled, this rule may be extremely useful[3] and may as a practical matter dispose of the trust issue for assets held by a Plan Assets Fund.[4]

Custody

Under ERISA Section 404(b), the indicia of ownership of plan assets must be subject to the jurisdiction of the U.S. district courts unless a regulatory exception applies.[5] Generally, under the Section 404(b) regulation, the indicia of ownership of certain assets may be held outside the jurisdiction of the U.S. district courts only if (i) the investments are held in custody under an exception for assets under the management and control of a qualified fiduciary (the Management-Based Custody Exception),[6] or (ii) an acceptable global-custody network or other acceptable custody arrangement is utilized.[7] The regulatory exception applies only to certain non-U.S. securities and currency;[8] thus the indicia of ownership of all other investments (e.g., U.S. securities, U.S. currency, property that is neither securities nor currency) must be subject to the jurisdiction of the U.S. district courts.

The Management-Based Custody Exception in the Section 404(b) regulation resembles the QPAM Exemption in some respects. Hence, where the status of the Plan Assets

Fund's manager is being relied upon under the Management-Based Custody Exception, certain issues noted above regarding qualification as a QPAM, such as issues for a first-year manager,[9] may similarly arise in the context of Section 404(b). However, the Section 404(b) regulation does not conform in all respects to the QPAM Exemption.[10] For example, in contrast to the QPAM Exemption, the applicable fiduciary generally must be organized and have its principal place of business within the United States.[11]

Where the Management-Based Custody Exception is not being used, it may be necessary to attempt to identify what the indicia of ownership of the plan's assets are[12] and to provide acceptable custody arrangements. Possible custody alternatives include (i) branches of U.S. banks or certain U.S.-registered brokers or dealers,[13] (ii) a qualifying network used by a U.S.-registered broker or dealer,[14] or (iii) a qualifying global custody network used by a U.S. bank.[15]

Bonding

General Scope of ERISA's Bonding Rules

Any person handling the assets of a Plan Assets Fund must be bonded as required by ERISA Section 412. The maximum bond is generally $500,000 per plan. In the collective investment context, some aspects of Section 412 may prove anachronistic or even arcane, and legislative developments have given rise to additional questions.

In 2008, the DOL issued Field Assistance Bulletin 2008-04 (the Bonding FAB),[16] which "provided various forms of guidance concerning the application of ERISA's bonding requirements" since the enactment of ERISA.[17] The Bonding FAB confirms that the is not the same as fiduciary liability insurance[18] and must only "protect the plan against loss by reason of acts of fraud or dishonesty on the part of persons required to be bonded, whether the person acts directly or through connivance with others."[19] By statute, a U.S.-registered broker or dealer subject to a fidelity-bond requirement of a self-regulatory organization no longer needs to be bonded.[20]

The Bonding FAB, by way of introduction, states that "ERISA Section 412 and related regulations . . . generally require that every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan shall be bonded."[21] The Bonding FAB then states, however, that "ERISA's bonding requirements are intended to protect employee benefit plans from risk of loss due to fraud or dishonesty on the part of persons who 'handle' plan funds or other property. ERISA refers to persons who handle funds or other property of an employee benefit plan as 'plan officials.'" Thus, despite the conjunctive listing of "fiduciar[ies]" and "plan official[s]" in Section 412(a), the Bonding FAB, in response to the question of whether "all fiduciaries must be bonded," states clearly: "No. Fiduciaries must be bonded only if they 'handle' funds or other property of an employee benefit plan and do not fall within one of the exemptions in section 412 or the regulations."[22]

This approach, which expressly recognizes the underlying purpose of Section 412, may be seen as a practical and reasonable application of the statute, notwithstanding the statute's linguistic nuances. Even with this relaxed approach, though, attention still must be paid to whether one is "handling" plan assets within the meaning of Section 412, a concept that could prove broader than some might expect.[23]

The need to review these issues may arise whether or not one believes a claim under the bond. While a claim under the bond may arise only if a plan official absconds with plan assets or engages in similar fraud or dishonesty, a fiduciary may have reputational risk if it fails to procure a required bond and that failure somehow comes to light. In addition, if a fiduciary permits another plan official to proceed without a required bond in place, the fiduciary may run afoul of the statutory provision that specifically states that:

> it shall be unlawful for any plan official . . ., or any other person having authority to direct the performance of [certain plan-related] functions, to permit such functions, or any of them, to be performed by any plan official with respect to whom the bonding requirements of [Section 412(a)] have not been met.[24]

Parties Subject to the Bonding Rules

Where a number of different related entities and other persons may handle plan assets in connection with the operation of a Plan Assets Fund, it may be worthwhile to confirm that the bond covers all relevant parties. For example, there may be feeders, and other affiliates could be handling plan assets.

Possibly offering some relief regarding the identification of parties that must be covered, the bonding regulations state: "regardless of the amount involved, a given duty or relationship to funds or other property shall not be considered 'handling,' and bonding is not required, where it occurs under conditions and circumstances in which the risk that a loss will occur through fraud or dishonesty is negligible."[25] The Bonding FAB adds:

> In the case of persons with supervisory or decision-making responsibility, the mere fact of general supervision would not, necessarily, in and of itself, mean that such persons are "handling" funds so as to require bonding. . . . Again, the general standard for determining whether a person is "handling" plan funds or other property is whether the person's relationship with respect to those funds is such that he or she can cause a loss to the plan through fraud or dishonesty.[26]

Maximum Bond Amount

The bonding rules refer to a $500,000 maximum bond per "plan" and, notwithstanding the modern trend toward collective investment, neither the statute nor the regulations (which are temporary regulations)[27] provide guidance as to how to apply the rules in a fund context. What if there are numerous plans? What if the identity of each plan investor is not known? What if even the number of plan investors is unknown? Possible solutions include buying one bond per plan investor, where feasible, or buying a blanket bond. Alternatively, a fund sponsor might require each investing plan to include all fund-related plan officials on the plan's bond. Some investors may balk at the notion of including outside entities and other persons in their bonds; others might not.[28]

More recently, ERISA Section 412 was amended to provide that if a plan holds employer securities, a bond of up to $1,000,000 could be required. This provision was added by the Pension Protection Act of 2006 in the wake of concern surrounding Enron and similar scandals.[29] The effectiveness of the amended provision is unclear, considering that bonding rules address the "risks of loss that might arise through dishonest or fraudulent acts in handling plan funds or other property,"[30] while

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wrongdoing regarding employer securities generally involves improper behavior at the underlying corporate employer. Nevertheless, the provision is now in the statute.

One issue with the $1,000,000 provision is that employer securities theoretically could have nothing to do with the particular plan assets invested in a given Plan Assets Fund, yet on its face the statute indicates that the bonding requirement could be as high as $1,000,000 plan-wide, including with respect to the Plan Assets Fund. Unfortunately, the Bonding FAB does not clarify the provision's reach as to these matters.[31]

Reporting

Reporting of Investments and Direct Filings with the DOL

Plans are subject to comprehensive reporting obligations under ERISA[32] and the Internal Revenue Code,[33] as applicable. Because information regarding the plan's investments must be provided,[34] these obligations will apply with respect to the assets of a Plan Assets Fund.[35] One possible way for a plan to satisfy its obligations with respect to investments made through the Plan Assets Fund is for the plan to report the investments of the Plan Assets Fund allocable to the plan on the plan's own IRS/DOL/PBGC Form 5500, essentially as though the plan had made the investments directly. In such a case, the Plan Assets Fund presumably would need to provide such information to its plan investors for the IRS/DOL/PBGC Form 5500 to be completed properly.

Another way to address the investing plan's IRS/DOL/PBGC Form 5500 obligations is for the Plan Assets Vehicle to become a direct filing entity (a DFE) under the DOL's regulations.[36] A DFE would file its own IRS/DOL/PBGC Form 5500 directly with the DOL with the required information, and the plan would attach to its IRS/DOL/PBGC Form 5500 information regarding the DFE.[37] A Plan Assets Fund seeking to proceed as a DFE can do so only if it "holds the assets of two or more plans that are not"[38] considered related under the DFE rules.[39] Thus, under a technical reading, the mere commingling of a single plan's assets (or the assets of a single group of affiliated plans) with those of other nonplans will not be sufficient to establish DFE status.[40]

Other Reporting Issues

Compensation-Related Issues

The administrator of a plan investing in a Plan Assets Fund may ask for compensation information in connection with its completion of its IRS/DOL/PBGC Form 5500 and specifically Schedule C thereto.[41] Even though the IRS/DOL/PBGC Form 5500 rules do not technically apply to those affiliated with the Plan Assets Fund but rather apply to the plan administrator,[42] the manager of the Plan Assets Fund will have an interest in cooperating with the reasonable requests of plan investors as the plan administrators prepare a IRS/DOL/PBGC Form 5500 satisfying the filing requirements.[43]

Hard-to-Value Assets

The application of ERISA's reporting requirements may be affected in other ways by a fund's operation as a Plan Assets Fund. One example is the way in which the reporting requirements may apply in the context of hard-to-value assets or in the case of investment by a fund of

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funds in interests in a portfolio fund with unclear value and the possible effect even on substantive investment strategy. In this regard, there are also specific obligations under Section 103(b)(3)(A) to file annual reports with assets at their "current value," and some funds may have provided valuations based on historical unaudited or reported bases without independent verification. Certain approaches to valuations may raise issues under applicable accounting rules.[44] There have been indications of DOL enforcement activity in this area.[45] Making an investment that is not susceptible to ready valuation conceivably could be viewed as a per se violation of Section 404(a)(1) of ERISA,[46] although it is by no means clear that ERISA should be viewed as sweeping so broadly.[47]

Gift and Entertainment Expenses

The reporting of gifts and gratuities presents another issue that could arise for Plan Assets Funds. For example, Plan Assets Funds may hold investor meetings that involve travel, meals, and entertainment,[48] and related reporting issues could be raised in addition to various substantive issues discussed above.[49]

Brokerage

In General

Under Prohibited Transaction Class Exemption 86-128 (PTCE 86-128), a fiduciary generally may effect or execute securities transactions on behalf of the plans for a fee, or use an affiliate to do so, without running afoul of ERISA Section 406(b), if the conditions of PTCE 86-128 are met. Section III(b)-(d) of PTCE 86-128 contain a number of generally applicable authorization, terminability and notice/information requirements. In the case of a Plan Assets Fund, special rules under Section IV(d) of PTCE 86-128 apply in lieu of the generally applicable rules, including a requirement under Section IV(d)(1)(C) that the investing plan be permitted to terminate its investment without penalty in the event of an objection to "the implementation of, material change in, or continuation of, the" fiduciary's use of its own services or the services of an affiliate to effect or execute such transactions. (It is noted that PTCE 86-128 applies only to the effecting or execution of securities transactions and thus, if transactions not involving securities are involved, another basis on which to proceed will need to be identified, if self-dealing concerns arise.)

"Prime Brokers"

In general terms, a prime broker, as colloquially known, is a financial institution that offers a package of services to funds and other investors, which may include, for example, custody and clearing services, programs for securities lending and other financing services. Because the relationship touches on a range of activities, a Plan Assets Fund, in establishing and maintaining a relationship with one or more prime brokers, may find that a wide variety of ERISA issues may arise. For example, transactions with (as well as the compensation of) the prime broker could raise concerns relating to prohibited transactions. A number of issues discussed elsewhere herein, including issues that may become more difficult or less difficult in the collective-investment context depending on which particular issue is involved, may find themselves relevant as the manager of the Plan Assets Fund (and the prime broker) attend to matters relating to documentation, administration and compliance.

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Thus, it would not be surprising if an agreement (or a package of agreements) for prime brokerage would contain provisions relating to whether plan assets are involved, prohibited transactions (and the availability of related exemptions), fiduciary status (or a lack thereof), the status of collateral as being (or not being) plan assets, custody, bonding, etc. Approaches to documentation, in terms of breadth, and in some cases which parties bear which risks, can be varied in the market, leading to different approaches depending on who the prime broker is and who the manager is.

Conclusion

Viewed through the prism of ERISA's laudable goals, its sometimes counterintuitive application may be better understood. This approach may be particularly helpful in the context of ERISA's application to a Plan Assets Fund, where the rules may not have been designed to accommodate modern modes of collective investing. Regardless of whether the effect under ERISA of utilizing collective investment is for better or for worse, once a manager decides to proceed with a multi-investor fund subject to ERISA, the manager needs to run the ERISA gauntlet or face the potential consequences of having failed to do so.

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[1] ERISA §403(a)(1).

[2] See 29 C.F.R. §2550.403a-1(b)(3) ("If the assets of an entity in which a plan invests include plan assets by reason of a plan's investment in the entity, the [trust requirements] are satisfied with respect to such investment if the indicia of ownership of the plan's interest in the entity are held in trust on behalf of the plan by one or more trustees."); see also 29 C.F.R. §2550.403a-1(b)(2) (similar rule for certain title-holding corporations). This result is not expressly applicable under the custody rules. See infra n.5 and accompanying text.

[3] Another regulatory provision permits the use

of nominees or holding in street name. 29 C.F.R. §2550.403a-1(b)(1) (providing in certain circumstances that the trust requirements "will not fail to be satisfied merely because securities of a plan are held in the name of a nominee or in street name.").

[4] An issue could still arise, for example, where a Plan Assets Fund acquires a financial instrument primarily for an indirect economic interest in an underlying asset, and the underlying asset could technically be subject to ERISA's trust requirement.

[5] 29 C.F.R. §2550.404b-1. There is no provision that would make ERISA §404(b) expressly inapplicable to "plan assets" held through a Plan Assets Fund.

[6] 29 C.F.R. §2550.404b-1(a)(2)(i). In certain situations involving custodial arrangements, the question of which persons are fiduciaries that have "management and control" for purposes of the Management-Based Custody Exception may not be entirely straightforward.

[7] Id.

[8] 29 C.F.R. §2550.404b-1(a)(1).

[9] See Part Three, nn.16-18 and accompanying text. Under the ERISA §404(b) regulation, 29 C.F.R. §1.404b-1(a)(2)(i)(C)(1), the issues for a new manager extend both to assets under management and to shareholders' or partners' equity.

[10] Although the two sets of rules have historically differed in some ways, the Management-Based Custody Exception has not been amended over time to conform to changes to the QPAM Exemption.

[11] 29 C.F.R. §2550.404b-1(a)(2)(i).

[12] A host of questions can arise. What if the interests are uncertificated? What if book entries are electronic? And what about financial instruments without traditional indicia of ownership? Is the point to identify physical possession? Or is it to identify the jurisdiction in which custody-related actions may be brought? Unfortunately, Or is it to identify the jurisdiction in which custody-related actions may be brought? Unfortunately, ERISA's custody rules in many respects have not kept pace with market practices regarding the manner in which assets are held.

[13] 29 C.F.R. §2550.404b-1(a)(2)(ii)(A).

[14] 29 C.F.R. §2550.404b-1(a)(2)(ii)(B).

[15] See 29 C.F.R. §2550.404b-1(a)(2)(ii)(C); see also DOL Adv. Op. 2008-04A (Apr. 8, 2008) (addressing a certain multinational custody platform). Some financial institutions have addressed the concatenation of custody and other practical issues that may arise under ERISA through platforms used specifically when acting in a cross-border setting in connection with swaps and other derivatives or acting as a "prime" broker or otherwise engaging in brokerage activities.

[16] DOL Field Assistance Bulletin 2008-04 (Nov. 25, 2008).

[17] Id., background section.

[18] Id. at Q&A 2.

[19] Id. at Q&A 1 (citation omitted).

[20] ERISA §412(a)(2).

[21] DOL Field Assistance Bulletin 2008-04, background section (citations omitted).

[22] Id. at Q&A 18.

[23] See generally 29 C.F.R. §2550.412-6; DOL Field Assistance Bulletin 2008-04 at Q&As 18-21.

[24] ERISA §412(b). Bonding may also be required by contract.

[25] 29 C.F.R. §2550.412-6(b)(2); see DOL Field Assistance Bulletin 2008-04 at Q&A 18.

[26] DOL Field Assistance Bulletin 2008-04 at Q&A 18; see 29 C.F.R. §2580.412-6(b)(6).

[27] 29 C.F.R. §2550.412-1; 29 C.F.R. pt. 2580.

[28] Alternatively, although there may not be apposite authority, one could take the position that for purposes of applying the $500,000 maximum, the applicable

"plan" is the single fund (i.e., the collective investment vehicle). This application of the bonding rule in the context of modern investment structures would arguably be a sensible one, as at least one group has specifically suggested. See generally American Bar Association, Section of Taxation, Comments on the New ERISA Bonding Rules Added by the Pension Protection Act of 2006, (Jan. 23, 2008). Nonetheless, DOL Field Assistance Bulletin 2008-04, which comprehensively addresses a range of bonding matters, offers no relief on this point. As noted above, see supra nn.18-19 and accompanying text, the DOL has in other respects interpreted the bonding rules in a way that may be more flexible than the literal statutory language suggests.

[29] See, e.g., 148 Cong. Rec. H1,217, 107th Cong., 2d Sess. (statement of Rep. Kind) ("The E[nron] scandal exposed weaknesses in our pension laws that could jeopardize these retirement savings. Hardworking Americans should not lose all of their retirement savings due to the wrong doing [sic] of corporate executives and loopholes in our pension laws. The legislation, while not perfect, will bring much needed improvements to our private pension system and help millions of American workers save for a happy and healthy retirement.").

[30] DOL Field Assistance Bulletin 2008-04 at Q&A 1.

[31] The DOL did address the $1,000,000 rule for employee securities in certain other respects. See id. at Q&A 36.

[32] See generally ERISA §§103-104.

[33] See generally 26 U.S.C. §§6047, 6057-6058.

[34] See generally 29 C.F.R. §103; IRS/DOL/PBGC Form 5500 (2010), sched. G.

[35] Other requirements of Form 5500 may also apply at the level of the Plan Assets Fund. See, e.g., IRS/DOL/PBGC Form 5500 (2010), sched. G, pt. III (relating to the reporting of nonexempt prohibited transactions).

[36] 29 C.F.R. §2520.103-12. The particular type of DFE relevant here is the so-called "103-12 investment entity" (103-12 IE).

[37] See IRS/DOL/PBGC Form 5500 (2010), scheds. D, H.

[38] 29 C.F.R. §2520.103-12(c).

[39] See 29 C.F.R. §2520.103-12(e).

[40] See also Part Three, n.20 (discussing the use of a similar formulation of a multi-investor requirement in a certain relief rule under the QPAM Exemption).

[41] The reporting of compensation may also raise issues under ERISA §408(b)(2). See Part Three, nn.38-47 and accompanying text. Unlike the §408(b)(2) rules, see Part Three, n.39, the Form 5500 fee-disclosure rules look through an "investment fund" whether or not the fund's assets are deemed to constitute "plan assets." See U.S. Department of Labor, Employment Benefits Security Administration, FAQs About the 2009 Form 5500 Schedule C, Q&As, Q3, 7.

[42] The §408(b)(2) rules require that: "Upon request of the responsible plan fiduciary or covered plan administrator, the covered service provider must furnish any other information relating to the compensation received in connection with the contract or arrangement that is required for the covered plan to comply with the reporting and disclosure requirements of Title I of the Act and the regulations, forms and schedules issued thereunder." 29 C.F.R. §2550.408b-2(c)(6)(A). While the requirement compels specific information to be furnished in response to requests on behalf of plans, it need not be interpreted in a way that could effectively amount to the wholesale importing of the Form 5500 rules into §408(b)(2). As a general matter, the rules governing §408(b)(2) diof Labor, Employment Benefits Security Administration, FAQs About the 2009 Form 5500 Schedule C; U.S. Department of Labor, Employment

sclosure, where applicable, will impact the service provider more directly than the Form 5500 rules. See generally Part Three nn.46-47 and accompanying text.

[43] See ERISA §§103-104; see also U.S. Department Employment Benefits Security Administration, Supplemental FAQs About the 2009 Schedule C; see also Now the DOL is FAQuing It: Having Fun with "Funds" on the Form 5500, posting of Andrew Oringer to BNA Pension & Benefits Blog (July 15, 2008, 18:56 EST). In addition, nonresponsive providers could be identified on what some have referred to as a proverbial "wall of shame" by virtue of information sought by the Form 5500 regarding such providers. See IRS/DOL/PBGC Form 5500 (2010), sched. C., pt. II ("Provide the requested information for each plan fiduciary or service provider who you believe failed or refused to provide any information necessary to complete Part I of this schedule."). Query, as well, whether a manager might have to disclose the existence of a discovered prohibited transaction as a result of the manager's status as a fiduciary, either because of Form 5500 requirements applicable to the plan administrator relating to the identification of prohibited transactions, or in light of more general fiduciary principles.

[44] See, e.g., Financial Accounting Standards Board Statement 157. Even where valuation issues arise, the relevant accountants should be consulted before concluding that a valuation problem ultimately rises to the level of an accounting problem. To the extent that a particular Plan Assets Fund or fund in which a Plan Assets Fund invests adopts more detailed or vigorous valuation procedures to address accounting concerns without regard to ERISA considerations, the issues that might have arisen under ERISA in this regard could become moot.

[45] See, e.g., Testimony of Virginia C. Smith, Director of Enforcement, Employee Benefits Security Administration, Before the Working Group on Hard to Value Assets/Target Date Funds Advisory Council on Employee Welfare and Pension Benefit Plans, September 11, 2008; see also Advisory Council on Employee Welfare and Pension Benefit Plans, Report on Hard to Value Assets and Target Date Funds (2008).

[46] See, e.g., Doug Halonen, DOL: Plan Fiduciaries Must Value Alts Accurately, Pens. & Invs. (Sept. 29, 2008). The use of so-called "side pockets" and similar investment structures for hard-to-value assets and other alternative investments may also raise a range of issues under §457A of the Code, in the case of Plan Assets Funds subject thereto. See generally New York State Bar Association, Tax Section, Employee Benefits Committee, Report on Rules Governing Nonqualified Deferred Compensation Under Section 457A, Report 1193 (Oct. 5, 2009), at §V(B).

[47] See A Report on Yet Another Reporting Issue for Private Equity and Other Investment Funds, posting of Andrew Oringer to BNA Pension & Benefits Blog (Aug. 15, 2008, 7:16 EST). Valuation issues may also arise under ERISA §406(b) in connection with various fees structures, see Part Four, nn.4-11 and accompanying text.

[48] See generally American Bar Association, Section of Taxation, Comments on the Proposed "Service Provider" Regulations Under Section 408(b)(2) of ERISA (Feb. 29, 2008), at §II(B); Michael A. Lawson & Andrew L. Oringer, A Report on Certain Reporting Issues Under ERISA: Disclosure of Fees for Services and Special Issues for Gifts and Entertainment, Pension Plan Investments 2009: Current Perspectives (Practicing Law Institute 2009).

[49] See Part Four nn.24-45 and supra nn.1-35 and accompanying text.